

**More Consideration Is Needed During  
Examinations to Identify Potential Fraud  
Issues and Refer Cases to Criminal  
Investigation**

**March 2001**

**Reference Number: 2001-30-063**

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DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

March 30, 2001

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

A handwritten signature in black ink that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner  
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - More Consideration Is Needed During  
Examinations to Identify Potential Fraud Issues and Refer Cases  
to Criminal Investigation

This report presents the results of our review to determine if Examination employees were referring cases to Criminal Investigation (CI) when appropriate. In summary, examiners and managers were not always recognizing or documenting that they recognized potential fraud issues on Examination cases, and therefore, were not always referring cases to CI as appropriate. We made four recommendations related to this issue.

Small Business/Self-Employed (SB/SE) Division management agreed with the recommendations included in the report and are planning to take corrective actions. However, they did not agree with the projection of potential fraud referrals and lost revenue because they did not agree that all 11 cases cited as potential fraud referrals should have been referred to CI. Management's comments have been incorporated into the report where appropriate, and the full text of their comments is included as an appendix.

Although SB/SE Division management did not agree with the projection, we believe that there was sufficient evidence of badges of fraud in the 11 cases to warrant referral to CI and that the projection based on these cases is valid.

Copies of this report are also being sent to the Internal Revenue Service managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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### **Executive Summary**

The Internal Revenue Service (IRS) mission is to provide taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. When taxpayers do not comply with tax laws, enforcement actions (such as the examination of their tax returns) are appropriate. When IRS employees examine returns and identify potential fraudulent issues, such as significant amounts of unreported income, they are to refer the cases to Criminal Investigation (CI). CI then decides whether to accept the cases and conduct investigations to determine whether the taxpayers criminally violated federal tax laws.

One of the Small Business/Self-Employed (SB/SE) Division's strategies to improve compliance with tax laws is to reenergize the Fraud Referral Program. CI has also made changes to its organization and has given a high priority to working cases involving income from legitimate sources (as opposed to illegal source cases, such as the selling of drugs). Many of these legitimate source cases could come from referrals from the Examination function within the SB/SE Division.

The overall objective of this audit was to determine whether Examination function employees refer cases with potential fraud issues to CI when appropriate.

### **Results**

Over the past few years, Examination function and CI executives have been concerned with the Fraud Referral Program and have attempted to identify ways to increase the number of quality fraud referrals. Efforts included a multi-function (Examination function and CI) task force and the implementation of its recommendations. Despite these efforts, fraud referrals from the Examination function to CI have continued to decline steadily over the past few years. The number of investigations per year resulting from referrals from the Examination function has declined from a high of 1,223 in Fiscal Year (FY) 1996 to only 256 in FY 2000. We learned several reasons for the decline during the audit.

The most current IRS effort to improve the Fraud Referral Program is to place groups of fraud specialists within the SB/SE Division area offices. This will increase the resources assigned to assist examiners in developing potential fraud cases. However, the SB/SE Division and CI can do more to help these fraud specialists and management improve the Fraud Referral Program.

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### **Indicators of Fraud Are Not Always Recognized and Cases Are Not Always Referred to Criminal Investigation When Appropriate**

Examination function managers and employees are not always recognizing and developing potential fraud issues, and therefore, are not referring some cases to CI when appropriate. We reviewed 100 closed Examination cases with total liabilities of approximately \$9 million to determine if potential tax fraud issues existed, in which event they should have been referred to CI. Our review identified 11 (11 percent) that met the criteria to be referred as potential criminal fraud cases; however, these cases had not been referred to CI. In addition, in 82 percent of the cases, the examiners did not document in the case file, as required, whether potential fraud was recognized and considered. The majority of these cases involved understated income. In addition, cases with understated income greater than \$10,000 require management involvement. However, management involvement in the cases related to documenting whether fraud was considered was not sufficient in 64 of the 80 cases in which the return had understated income over \$10,000.

Examiners and managers gave three overall reasons for not making referrals:

- The IRS Restructuring and Reform Act of 1998<sup>1</sup> has made employees reluctant to refer cases because they are concerned that taxpayers will retaliate and complain, and as a result, employees will be punished.
- Examination function employees are disinclined to make fraud referrals because of their perceptions of how frequently CI rejects their referred cases.
- Examination function employees are concerned that they are no longer working the types of cases that result in referrals. For example, the number of small business individual returns<sup>2</sup> examined has decreased from 139,261 in FY 1998 to 64,091 in FY 2000.

If the IRS does not address tax fraud among those who do not comply, the potential exists for decreased taxpayer compliance among those taxpayers who generally do comply. Based on our statistically valid sample of the 100 cases, we estimate that an additional 381 cases nationwide had potential fraud issues that could have been referred to CI during our 16-month sample period. We also estimate that during our 16-month sample period there could have been approximately \$21.8 million in additional revenue from assessing civil fraud penalties on the cases with potential fraud issues that did not already

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<sup>1</sup> Pub L. No. 105-206, 112 Stat. 685.

<sup>2</sup> This refers to examinations of U.S. Individual Income Tax Return (Form 1040) with a Profit or Loss From Business or Farming (Schedule C or F, respectively). These types of returns have a higher potential for fraud issues.

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have the penalty asserted.<sup>3</sup> Civil fraud penalties are asserted on the additional tax liability for cases with fraud issues.

### **Summary of Recommendations**

We recommend that the Commissioner, SB/SE Division, enhance the processes that identify cases with potential fraud issues through various methods, such as requiring certain cases to be discussed with fraud specialists. The Commissioner, SB/SE Division, should also adjust the mix of cases being examined to include more returns that have historically yielded fraud potential. In addition, the Commissioner, SB/SE Division, and the Chief, CI, should show front-line employees their commitment to the Fraud Referral Program by regularly emphasizing its priority and setting clearer guidelines on what constitutes a successful fraud referral.

Management's Response: SB/SE Division management agreed with the recommendations. They plan to have the fraud referral specialists work with examiners on open cases, identify trends and patterns of non-compliance, and identify training needs. They also plan to set a dollar threshold for cases that are required to be discussed with the fraud referral specialists and remind managers to document involvement in potential fraud cases. The Commissioner, SB/SE Division and the Chief, CI, will issue a joint memorandum emphasizing the importance of the program, and CI will provide feedback to the SB/SE Division on successful fraud referrals and assist in training the fraud referral specialists. SB/SE Division management also will be increasing the time allocated to high-income filers, including those filing Schedule C and F returns.

SB/SE Division management did not agree with the projection of potential referrals and lost revenue. Management's complete response to the draft report is included as Appendix VI.

Office of Audit Comment: Although management did not agree with the projection in the report, we believe that our review of cases identified sufficient evidence of badges of fraud in the 11 cases we used as a basis for our projection.

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<sup>3</sup> The IRS had assessed the penalty on 2 of our 11 cases that should have been referred to CI. Therefore, we based our calculation on the remaining 9 cases.

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### Objective and Scope

*The audit's objective was to determine whether Examination function employees refer cases with potential fraud issues to CI when appropriate.*

The overall objective of this audit was to determine whether Examination function employees refer cases with potential fraud issues to Criminal Investigation (CI) when appropriate.

To accomplish this objective, we:

- Reviewed the procedures in place for developing fraud issues on Examination cases and referring cases to CI.
- Reviewed a nationwide statistical sample of 100 closed Examination cases with adjustments over a specified dollar amount to determine whether fraud issues were being identified by examiners and managers, discussed with the district fraud coordinators (DFC), and referred to CI if appropriate. One "case" included all tax years being examined for a specific taxpayer. Each case had a large dollar tax adjustment which is one of the criteria for a referral. These cases had a variety of tax issues such as understated income, overstated expenses, and changes to accounting methods.

Details of our sampling methodology, including the population, confidence level, error rate and precision rate are included in Appendix I.

- Determined the reasons for the low number of referrals by discussing concerns with CI and Examination function management and examiners.

We conducted audit tests in the Atlanta, Dallas, and Southern California Internal Revenue Service (IRS) field offices and the National Headquarters between September and December 2000. This audit was performed in accordance with *Government Auditing Standards*.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.



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### Background

The IRS mission is to provide taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all. When taxpayers do not comply with tax laws, enforcement actions (such as the examination of their tax returns) are appropriate. The Commissioner and Deputy Commissioner, Small Business/Self-Employed (SB/SE) Division, are emphasizing refocusing field resources on core compliance activities and improving business results in the Examination and Collection functions to address non-compliant taxpayers.

The SB/SE Field Examination Program consists of tax auditors who conduct examinations of individual returns that require a face-to-face interview at IRS locations, and revenue agents who conduct examinations of the most complex returns at a taxpayer's place of business. Tax auditors and revenue agents are also known as examiners.

*The SB/SE Division has a strategy to reenergize the Fraud Referral Program. The Fraud Referral Program is part of the IRS' overall fraud program, the objective of which is to foster voluntary compliance by recommending criminal prosecution and/or civil penalties against taxpayers who evade the payment of taxes.*

One of the strategies to meet the SB/SE Division's goal of improving compliance is for the Field Examination function to reenergize the Fraud Referral Program by strengthening the focus on potentially fraudulent issues encountered in the population of SB/SE taxpayers, particularly among small businesses. The objective of the IRS' overall fraud program is to foster voluntary compliance through the recommendation of criminal prosecution and/or civil penalties against taxpayers who evade the payment of taxes known to be due. The Examination function's Fraud Referral Program is part of the IRS' overall fraud program.

Tax examination cases begin to become fraud referral cases when examiners recognize affirmative indications and acts of fraud by taxpayers. These indications are called "badges of fraud." Examples of badges of fraud are substantial understated income with no explanation; certain taxpayer conduct, such as being deceptive or not providing information; and false documentation. Once badges of fraud are identified during examinations,

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*CI is also reemphasizing the Fraud Referral Program as part of its goals.*

examiners are required to develop the issues sufficiently to be able to refer the cases to CI for criminal investigation. This includes discussing the cases with their manager and soliciting the assistance of the DFC. If cases are referred, CI then decides whether to accept the cases and conduct investigations to determine whether the taxpayers criminally violated federal tax laws. If there are fraud issues on a case, Examination function managers can decide to assert a civil fraud penalty of 75 percent on the additional tax liability, regardless of whether it is a civil or criminal fraud case. The difference between civil and criminal fraud is the intent of the taxpayer.

CI is also reemphasizing the Fraud Referral Program as part of its goals, based on recommendations from Congressional hearings and an independent study<sup>1</sup> conducted of its activities. One of CI's goals is to work more tax fraud cases involving income from legitimate sources (as opposed to illegitimate source cases, such as the sale of drugs), which in many instances are the fraud referrals coming from the Examination function. CI has hired new staff to help meet this challenge.

Currently, with the renewed interest in the Fraud Referral Program, there are plans to place groups of fraud specialists within the SB/SE Division area offices. This will significantly increase the resources assigned to assist examiners in developing potential fraud cases. These fraud specialists will conduct work similar to the current DFCs who provide advice and assistance to examiners as they develop fraud issues on cases. There will no longer be DFCs once the fraud specialists are selected.

## Results

Over the past few years, Examination function and CI executives have been concerned with the Fraud Referral

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<sup>1</sup> *Review of the IRS Criminal Investigation Division Conducted by the Honorable William H. Webster, April 1999.*

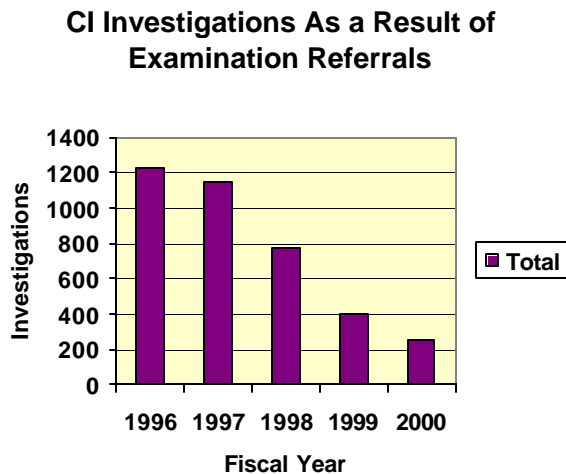
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Program and have attempted to identify ways to improve the program so there will be an increase in referrals. Some examples of these actions were: convening a multi-functional (Examination function and CI) task force in 1995 and implementing most of its recommendations; establishing the position of DFC who acts as a liaison between CI and the Examination function; and following up in 1997 on the 1995 task force's recommendations.

Despite these efforts, referrals from the Examination function to CI have continued to decline over the past few years. The number of investigations per year resulting from referrals from the Examination function has declined from a high of 1,223 in Fiscal Year (FY) 1996 to only 256 in FY 2000. At the same time, the rate at which CI rejected referrals from the Examination function has increased in four of the past five years, the single exception being FY 2000. The following charts illustrate this:

*The number of CI investigations resulting from Examination referrals has been decreasing since FY 1996, and the percentage of cases rejected by CI has increased in four of the past five years.*

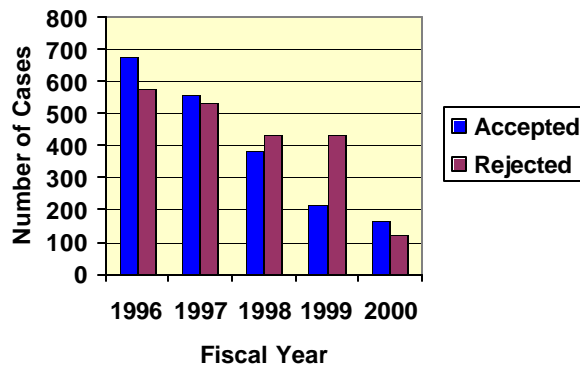


Source: Criminal Investigation Division

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**Number of Cases Accepted and Rejected By CI**



Source: Criminal Investigation Division

*Auditor's Note: Investigations can be the result of cases that were accepted in a prior year. Therefore, the numbers for each fiscal year in the first chart will not match those from the same fiscal year in this chart.*

While both the SB/SE Division and CI are taking steps to improve the Fraud Referral Program, more can be done to increase its chances of success.

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### Indicators of Fraud Are Not Always Recognized and Cases Are Not Always Referred to Criminal Investigation When Appropriate

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Examination function managers and employees are not always recognizing and developing potential fraud issues, and therefore, are not referring some cases to CI when appropriate. As previously stated, examiners are required to identify whether badges of fraud exist when conducting examinations and to refer the cases to CI for investigation if appropriate. Managers should be involved in this decision.

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*Eleven of 100 sample cases had sufficient evidence of badges of fraud to be referred to CI; however, they were not referred.*

Our review of 100 closed Examination cases with total liabilities of approximately \$9 million identified 11 (11 percent) that met the criteria to be referred as potential criminal fraud cases; however, these cases had not been referred to CI. Although Examination function management did consider 2 cases to be civil fraud and asserted the civil fraud penalty on these cases, all 11 cases' documentation indicated that the examiners obtained sufficient evidence that more than one badge of fraud was present and there was potential criminal fraud intent. Some examples of the badges of fraud on these cases were: unexplained, substantial unreported amounts of income; bank deposits that substantially exceeded income reported; and taxpayers who occasionally attempted to hinder the examinations or who provided false statements. Hypothetical examples with more details are included in Appendix V.

In our discussions of these cases with Examination function and CI management, CI management agreed that all 11 cases should have been referred. On the other hand, while Examination function management agreed that there were potential fraud issues that should have been developed further in 7 of the 11 cases, they did not believe the cases should necessarily have been referred. These different conclusions further indicate that clarification is needed between the Examination function and CI as to when a case should be referred.

Also, in 82 cases (82 percent), the examiners did not document in the case file, as required, whether potential fraud was recognized and considered. The majority of these cases involved understated income as the issue.

Cases with understated income have the most potential of becoming criminal fraud cases. In addition to examiners being required to document that fraud was considered on these cases, group managers are required to discuss all cases with understated income in excess of \$10,000, for the purpose of considering possible fraudulent activity by the taxpayer.

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*Managers were not sufficiently documenting that cases with understated income as an issue had fraud considered.*

Eighty cases met this criteria, and group manager involvement was not sufficient in 64 (80 percent) of them. In 22 cases, we could not identify any evidence of managerial involvement, and in 42 cases, although there was indication of managerial involvement, no documentation existed showing fraud was discussed.

### **Reasons why these problems occurred**

*The reasons for the low number of fraud referrals cited most often by managers and employees were the RRA 98, CI's rejection of cases, and workload issues.*

Discussions with 28 CI and Examination function managers and employees yielded various causes why fraud issues are not being developed and cases not being referred to CI. The reasons they gave most often can be categorized as follows.

- The IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>2</sup> has made many Examination function employees fearful of participating in the Fraud Referral Program because to do so might bring about a termination for misconduct. Twenty-four managers and examiners said the RRA 98 was a factor for the low number of referrals. Due to cumbersome practices and fear of taxpayer retaliation and complaints, employees are concerned about being aggressive on cases and developing fraud cases. Managers and employees specifically told us:

“...[the] post-RRA 98 atmosphere has Examination staff hesitant to pursue any fraud referral action that may be construed as hostile or detrimental to a taxpayer... Revenue agents are reluctant to do or say anything that may upset a taxpayer...”

“...RRA 98 has taken away some of our research tools to develop project cases...”

“...RRA 98 has made the administrative procedures overwhelming...”

- Examination function employees are disinclined to make fraud referrals because of their perceptions of

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<sup>2</sup> Pub L. No. 105-206, 112 Stat. 685.

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how often CI rejects their referred cases. Sixteen managers and examiners said that the general attitude towards CI rejections was a factor in the low number of referrals. There is a feeling that CI rejects more cases than it accepts;<sup>3</sup> therefore, they questioned why they should work hard to develop cases just to have them rejected. In addition, there is a perception that CI does not work many tax cases coming from the Examination function and prefers to work other types of cases.

- Nineteen managers and examiners said workload issues were a factor in the low number of referrals. Some are concerned that they are not working as many cases as in past years that would yield fraud. Also, many employees have been detailed to work on other than compliance-type work, such as helping taxpayers during the filing season.

To further evaluate whether workload was a factor, we analyzed Table 37, *Examination Program Monitoring*, for a 3-year period. This analysis showed a significant decline in examinations of U.S. Individual Income Tax Return (Form 1040) having Profit or Loss From Business (Schedule C) and/or Profit or Loss From Farming (Schedule F) attached. These types of returns have a higher potential for fraud issues. The following table provides details of the declining numbers of such examinations:

### Decline in the Number of Examinations Conducted of Schedule C and F Returns

Fiscal Year	Examinations of Schedule C and F Returns
1998	139,261
1999	97,829
2000	64,091

Source: Table 37, *Examination Program Monitoring*

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<sup>3</sup> As the earlier chart showed, this was, in fact, true during FYs 1998 and 1999. The perception, at least during those two years, was reality.

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In addition, examiners do not clearly understand all the situations when CI might accept a case as a criminal fraud referral. For example, examiners informed us that they believe CI will only take cases involving multiple tax years. Generally, CI does prefer cases with multiple year patterns; however, CI will accept one-year cases that are egregious. Also, examiners thought a case where the taxpayer does not come to the appointment with the IRS could not be a referral. Again, this may be correct when there is no other information in the case file. However, if there is a situation where the IRS has third-party information verifying that the taxpayer had large amounts of unreported income, for example, the case could be referred.

### **Effects of not recognizing fraud issues on cases and not referring cases to CI**

*Not referring cases with fraud issues will keep the SB/SE Division and CI from meeting their goals for the program, could possibly decrease taxpayer compliance, and result in lost revenue due to penalties not being assessed.*

The SB/SE Division and CI will not meet their goals if fraud issues are not being developed on cases. Consequently, both have begun reemphasizing the need to reinvigorate the Fraud Referral Program. If the IRS does not address tax fraud among those who do not comply, the potential exists for compliance to decrease among those taxpayers who generally do comply.

Based on our statistically valid sample of 100 cases, we estimate that an additional 381 cases nationwide had potential fraud issues that could have been referred to CI during our 16-month sample period. In addition, the 11 cases we determined could have been referred to CI potentially could have yielded additional civil fraud penalties in 9 instances if they had been worked as fraud cases. (Two cases already had civil fraud penalties assessed.) Estimating this across the population, we determined that during our 16-month sample period there could have been approximately \$21.8 million in additional revenue from assessing civil fraud penalties on the cases that could have been referred to CI. Civil fraud penalties are asserted on the additional tax liability for cases with fraud issues.



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### **A comparable IRS study identified similar conditions**

One SB/SE field office performed a comparable case review study in FY 2000 using an objective similar to ours. Their analysis showed that fraud should have been considered in 25 percent of the cases, but there was no evidence it was considered.

### **Recommendations**

1. The Commissioner, SB/SE Division, needs to enhance Examination function processes to more readily identify cases with potential fraud issues.
  - a. The new fraud specialists should be used to identify open cases with potential fraud issues on which they can provide advice.
  - b. It should be mandatory that cases with understated income over a certain dollar amount be discussed with the new fraud specialists.
  - c. The new fraud specialists should conduct closed case reviews to identify both best practices and problem trends, in order to be able to educate examiners to help them better identify and develop fraud issues in the future.
  - d. Managers should include a discussion of potential fraud in all their reviews of the examiners' work, whether detailed case reviews or not, and document the discussion.
2. The Commissioner, SB/SE Division, and the Chief, CI, need to continue demonstrating to front-line employees their commitment to the Fraud Referral Program and regularly emphasize the priority it has. High-level executive communications should include publicizing successful referrals.
3. The Chief, CI, needs to set clearer guidelines and definitions for examiners as to what are considered fraud issues, what makes a successful referral, and what will be accepted and why.
4. As the SB/SE Division hires new examiners, the Commissioner, SB/SE Division, needs to adjust the

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mix of cases being examined, specifically by increasing the number of Schedule C, F, and other source returns that have historically yielded cases that have fraud potential.

Management's Response: SB/SE Division management agreed with the recommendations and are planning the following corrective actions. They plan to have the fraud referral specialists work with examiners on open cases, identify trends and patterns of non-compliance, and identify training needs. They also plan to set a dollar threshold for cases that are required to be discussed with the fraud referral specialists and remind managers to document involvement in potential fraud cases. The Commissioner, SB/SE Division, and the Chief, CI, will issue a joint memorandum emphasizing the importance of the program, and CI will provide feedback to the SB/SE Division on successful fraud referrals and assist in training the fraud referral specialists. SB/SE Division management also will be increasing the time allocated to high-income filers, including those filing Schedule C and F returns.

Although SB/SE Division management agreed with the recommendations, they did not agree with the projection of potential referrals and lost revenue because they did not agree that all 11 cases cited as potential referrals should have been referred.

Office of Audit Comment: We believe that there was sufficient evidence of badges of fraud in the 11 cases to warrant referral to CI and that the projection is valid. As mentioned on page 6 of the report, we discussed the cases with a representative from CI who also agreed there were sufficient badges of fraud in the cases to warrant referral.

## **Conclusion**

Although the IRS continues to try to reenergize the Fraud Referral Program by changing procedures or organizational set-up, front-line examiners and managers are the ones who identify fraud potential, and that will not change. If examiners and their managers do

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not identify the fraud issues when they perform their examinations and feel comfortable developing the fraud issues, the number of referrals will not increase and will adversely impact overall taxpayer compliance. Working together, the SB/SE Division and CI can make some changes that will increase the likelihood of success for the Fraud Referral Program.

### **Detailed Objective, Scope, and Methodology**

The overall objective of this audit was to determine whether Examination function employees refer cases with potential fraud issues to Criminal Investigation (CI) when appropriate. To accomplish the objective, we conducted the following audit tests.

A major portion of our audit involved a review of closed Examination cases. We used statistical sampling methods to select a nationwide sample of cases. The nationwide sample included cases closed by the Examination function over a 16-month period (January 1999 through April 2000). The details of our methodology are contained in Audit Tests II.A and II.B below.

- I. Determined the Internal Revenue Service's (IRS) procedures and key controls for Examination referrals to CI.
  - A. Reviewed the Internal Revenue Manual (IRM), the handbook entitled, *ADP and IDRS Information* (Document 6209), the Interim CI Compliance Strategy Document, the Law Enforcement Manual (LEM), and other IRS directives related to fraud referrals to identify the criteria and flowchart the process and controls.
  - B. Identified the following key statistics related to the Fraud Referral Program for Fiscal Years (FY) 1996 through 2000.
    1. Total cases referred from the Examination function to CI.
    2. Cases referred from the Examination function and accepted by CI.
    3. Cases referred from the Examination function and rejected by CI.
    4. Examination Quality Measurement System (EQMS) statistics related to fraud (FY 2000 only).
  - C. Evaluated the fraud referral process within the National Headquarters and the Atlanta, Dallas, and Southern California field offices.
    1. Discussed with National Headquarters' employees the current status of changes to the Fraud Referral Program as it relates to the IRS' reorganization and modernization efforts.
      - a) Identified the new process planned for FY 2001.
      - b) Determined whether recommendations from prior task forces, reports, and feedback on the Fraud Referral Program were considered.

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- c) Determined whether there were any changes planned specifically for examiners' responsibilities for identifying badges of fraud<sup>1</sup> during the course of an examination.
  - 2. Determined the procedures that are currently in place for group manager review and district fraud coordinator (DFC) involvement.
  - 3. Determined the type and extent of communication between the Examination function and CI regarding criteria for fraud referrals and the reasons for acceptance and rejection of fraud referrals through interviews in the three field offices.
    - a) Identified training and instructions provided to Examination function employees.
    - b) Determined how CI communicated what is an "adequately developed" fraud referral and why it rejects cases.
    - c) Identified the number of cases accepted and rejected in the Atlanta and Dallas field offices visited. We did not obtain this information in the third office visited (Southern California) because of the small number of cases.
    - d) Determined from the Examination function and CI the reasons cases are rejected.
    - e) Discussed with Examination function employees whether the rejection rate affected whether they refer cases to CI.
  - 4. Determined how the civil fraud penalty was being used as part of the overall Fraud Referral Program by discussing with managers in the three field offices when the penalty is applicable and who is responsible for determining on which cases to assert the penalty.
- II. Determined whether fraud issues were being appropriately developed by Examination function employees by reviewing the effectiveness of case actions and determining if cases met the criteria for a fraud referral but were not adequately developed and referred.

We statistically selected a nationwide sample of closed Examination cases to accomplish this objective as follows. *(Note: One "case" equals a taxpayer and could include more than one tax year for the same taxpayer.)*

- A. Identified cases for review by performing the following analyses of closed Examination cases from the IRS' main computer data:

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<sup>1</sup> Badges of fraud include substantial understated income with no explanation; certain taxpayer conduct such as being deceptive or not providing information; and false documentation.

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1. Obtained the nationwide population of cases closed by the Examination function between January 1, 1999, and April 30, 2000, having an aggregate tax deficiency over a specified dollar amount (12,992 total cases).
  2. Using the results from II.A.1, identified the number of cases where taxpayers were small business taxpayers who filed a U.S. Individual Income Tax Return (Form 1040) with a Profit or Loss From Business (Schedule C) or Profit or Loss From Farming (Schedule F) (3,652 total cases).
  3. Using the results from II.A.2, identified the cases that did not have any indication that they were worked by CI. This indicated that the cases had not been referred to CI as fraud cases (3,465 total cases).
  4. Identified cases from II.A.2 that were worked by CI (187 total cases). [Requested 25 of these cases to only use for research and as a guide as we conducted our case reviews.]
- B. Selected a nationwide statistical sample of 100 cases using the population of 3,465 total cases identified in II.A.3. For our statistical sampling criteria, used a 98 percent confidence level, and a +/-5 percent error rate and precision rate.
- C. For the 100 cases selected, reviewed documented case actions to determine if it appeared badges of fraud and LEM criteria were present but not considered during the examination.
1. Discussed criteria for the case review with Examination function and CI management.
  2. Used the following criteria as basis for our review:
    - a) Badges of fraud listed in the IRM.
    - b) EQMS criteria.
    - c) Interim CI Compliance Strategy Document.
    - d) LEM.
  3. Developed a case review checksheet to capture information from each case reviewed.
  4. Reviewed each case to determine whether any badges of fraud were present. If there were badges of fraud present, identified them and determined whether the case should have been referred to CI or discussed with the manager or DFC. Included whether:
    - a) There was evidence in the case documentation that fraud was considered.

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- b) The examiner obtained from the taxpayer all information needed to develop a fraud case.
    - c) There was indication that the case was discussed with the local DFC and/or manager.
    - d) The case was discussed for fraud issues, but was rejected by the manager, DFC, or CI.
    - e) The civil fraud penalty was appropriately applied.
  - 5. Discussed our conclusions from the case review with CI to determine if CI agreed that certain cases had potential fraud issues and should have been referred to them.
  - 6. Discussed our conclusions from the case review with Examination function managers to obtain their opinion.
  - 7. Identified trends for cases meeting the fraud referral criteria yet not referred.
  - D. Contacted the Office of Strategy, Research and Performance Analysis to assist in estimating the potential civil fraud penalties that could have been assessed if cases had been referred to CI.
- III. Determined the reasons and underlying causes for why Examination function employees and managers had not been referring cases to CI although potential fraud issues existed. To accomplish this, conducted discussions with 28 Examination function and CI personnel in the 3 field offices and the National Headquarters.

**Major Contributors to This Report**

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**Appendix III**

**Report Distribution List**

Commissioner N:C  
Deputy Commissioner N:DC  
Director, Compliance, Small Business/Self-Employed Division S:C  
Chief, Criminal Investigation CI  
Area Director of Compliance, Atlanta, Small Business/Self-Employed Division S:C  
Area Director of Compliance, Dallas, Small Business/Self-Employed Division S:C  
Area Director of Compliance, Laguna Niguel, Small Business/Self-Employed Division  
S:C  
Director, Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O  
National Taxpayer Advocate TA  
Chief Counsel CC  
Office of Management Controls N:CFO:F:M  
Audit Liaisons:  
    Small Business/Self-Employed Division S:C:CP:I  
    Criminal Investigation CI:S:PS

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### **Appendix IV**

#### **Outcome Measures**

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

##### Type and Value of Outcome Measure:

- Increased Revenue - Potential: \$21.8 million (see page 9).
- Increased Revenue - Potential: 381 taxpayers impacted (see page 9).

##### Methodology Used to Measure the Reported Benefits:

#### **General Population Information for Both Outcome Measures**

We obtained the nationwide population of cases closed by the Examination function between January 1, 1999, and April 30, 2000, (16 months) having an aggregate tax deficiency over a certain dollar amount; there were a total of 12,992 cases meeting our criteria. Of the 12,992 cases, we then identified 3,465 small business taxpayers who filed a U.S. Individual Income Tax Return (Form 1040) with a Profit or Loss From a Business (Schedule C) or Profit or Loss From Farming (Schedule F), with no Criminal Investigation (CI) activity. We statistically sampled cases from the population of 3,465 cases using a 98 percent confidence level and +/-5 percent error rate and precision rate to arrive at 100 cases for our review.

#### **Outcome Measure - \$21.8 million**

Of the 100 cases reviewed, we determined that 11 met the criteria to be referred as potential criminal fraud cases. Two cases had the civil fraud penalty assessed; the aggregate underpayment of tax of the other 9 cases was \$837,978. The estimated civil fraud penalties for these 9 cases would be \$628,483 based on the 75 percent civil fraud penalty rate. These 9 cases represent 9 percent of the sample. Calculating 9 percent of the 3,465 population would yield 312 cases. Therefore, 312 cases potentially could have had civil fraud penalties recommended and assessed. The estimated average dollar civil fraud penalty on the 9 cases was \$69,831, and multiplying that by 312, we calculated \$21,787,272 as potential additional civil fraud penalties over the 16-month sample period.<sup>1</sup> This is an average amount.

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<sup>1</sup> Based on the confidence level of 98 percent, and precision and error rates of +/- 5 percent for our sample and the variance from the mean (standard deviation) for the potential penalty amounts of the 9 cases, the lower bound for the estimated additional penalties is \$5.6 million and the upper bound is \$38.0 million.

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### **Outcome Measure - 381 Taxpayers**

We identified 11 (11 percent) of the 100 cases that could have been referred to CI. Using 11 percent as representative of the universe, we determined that 381 taxpayers could be impacted (11 percent of our nationwide population of 3,465 cases that could have been fraud referrals over the 16-month sample period).

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### **Appendix V**

#### **Hypothetical Examples of Scenarios Where There Is Potential for Fraud**

This appendix presents hypothetical examples of scenarios of potential fraud that examiners should recognize, develop, and refer to Criminal Investigation. These examples do not represent actual taxpayers.

##### **Example One**

Assume that Mr. Taxpayer A owns a business and only reported on his income tax return a net profit of \$15,000 for one tax year and \$30,000 for the following year.

An examination of the bank statements indicated that daily deposits of the cash receipts were not made and the majority of deposits were direct credit card receipts. Assume there was some evidence that the taxpayer had structured transactions to avoid the currency reports required when deposits were \$10,000 or greater and that most of the expenses were paid in cash.

Also assume that Mr. Taxpayer A purchased a home the first year for the amount of \$1 million and a new automobile the next year for the amount of \$25,000, paid for in cash. A down payment of \$250,000 was made on the home and later, an additional amount of \$100,000 was paid. The sources of these payments were unknown. Monthly mortgage payments were over \$7,000 and the application for the mortgage showed annual income of \$200,000, which was not supported by the income tax return. The taxpayer provided unsubstantiated claims regarding the receipt of cash and loans from different sources.

In this hypothetical example, some of the badges of fraud<sup>1</sup> that could be identified are:

- Large amounts of unexplained, substantially understated amounts of income.
- Standard of living in excess of the income reported.
- Bank deposits from unexplained sources substantially exceeding reported income.
- Failure to deposit receipts to business accounts.
- Covering up sources of receipts by false descriptions of sources of disclosed income.

##### **Example Two**

Assume Mr. Taxpayer B is in business and Mrs. Taxpayer B only works part-time and has a small income. Assume the taxpayers did not file tax returns for 5 years. In the following 2 years, they filed their income tax returns using the wife's social

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<sup>1</sup> Badges of fraud include substantial understated income with no explanation, certain taxpayer conduct such as being deceptive or not providing information, and false documentation.

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security number. They showed minimal income for the wife's job and no income for Mr. Taxpayer B. These returns were filed so the taxpayers could claim the Earned Income Credit (EIC). EIC is a tax credit for people who work and earn income under a certain dollar amount that results in less tax due and can, in some situations, result in a tax refund.

Also, assume Mr. Taxpayer B participated in a trust scheme where he reported only a part of his income from Forms 1099. (Forms 1099 show miscellaneous income earned and the amounts are reported to the Internal Revenue Service.) During the examination, Mr. Taxpayer B refused to provide any information related to this "trust" account or other income shown on the Forms 1099 that was not reported.

Badges of fraud that could be identified are:

- Understatement of income.
- Failure to file a return for a period of several years.
- Incorrect entries on the return for the purpose of claiming the EIC.
- Phony (sham) trust return filed.
- Taxpayer's failure to answer pertinent questions and refusal to provide records.

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**Appendix VI**

**Management's Response to the Draft Report**

**The response has been removed due to its size. To see the complete response, please go the Management Response file on the TIGTA Public Web Page.**